Voltaire
ADVISORS

28 FEBRUARY 2017

VALUATION OF ALTERNATIVE ASSETS FOR INVESTMENT FUNDS

ARMY & NAVY CLUB,
36 PALL MALL,
LONDON

A Briefing on Valuation of Alternative Assets for Investment Funds

The US Securities and Exchange Commission (SEC) have recently expressed concern over the valuation of investments made in alternative asset classes such as private equity, debt and real estate. In particular, the Commission has encountered significant divergence in the pricing of widely held private securities such as 'Unicorns'.

The scope for mis-valuation of private investments – whether by error or design – is extremely high. Widespread use of internal models, highly sensitive to calibration assumptions, can result in wildly differing results and there is a strong need for consistency in valuation practices.

This Briefing includes a keynote presentation from Lisa Cawley, partner at Kirkland & Ellis, on the prospects for private fund regulation post-Brexit. Lisa will also look at the upcoming review of AIFMD due this summer.

To assist with planning and strategy for overburdened fund CFO's, accountants and administrators facing these problems we have organized a series of expert panels. These discussions will review valuation issues in each asset class and help to answer questions on current developments.

08.30 - 09.30	Registration – Coffee & Breakfast
09.00 - 09.30	**Introduction – Lisa Cawley, Partner, Kirkland & Ellis** Review of current regulatory landscape for private funds & prospects for AIFMD II
09.30 - 10.15	**Private Debt** **Moderator – Ian Blance**, *Managing Director, Voltaire Advisors* **Mark McMahon**, *Managing Director, Alvarez & Marsal* **Ryan McNelley**, *Managing Director, Duff & Phelps* **Leon Sinclair**, *Director, IHS Markit*
10.15 - 10.45	Coffee
10.45 - 11.30	**Private Equity** **Moderator – Claire Wilson**, *Editor, Private Funds Management* **Richard Bibby**, *Managing Director, Alvarez & Marsal* **Ryan McNelley**, *Managing Director, Duff & Phelps* **Leon Sinclair**, *Director, IHS Markit*
11.30 - 12.00	**Real Estate** **Moderator – Ben Elder**, *Global Director of Valuation, RICS* **Ollie Saunders**, *Lead Director - Alternatives, JLL* **Chris Thorne**, *Managing Director, Valuology* **Keenan Vyas**, *Director, Duff & Phelps*
12.00	Wrap Up & Close of Briefing

Ian Blance

Ian Blance is Managing Director of Voltaire Advisors. Ian has over 30 years' experience in the financial markets focused on research and valuation of securities and derivatives. He is a regular commentator on valuation and risk issues in the media and a frequent conference speaker.

In his earlier career Ian developed and ran securities valuation operations for two of the major information vendors and has provided consulting services for the others. Ian spent 4 years as Head of Evaluated Pricing for SIX Financial Information, based in Zürich, Switzerland and 12 years with Interactive Data Corporation, setting up and building their fixed income valuations business in London and subsequently becoming Managing Director of the market leading Evaluated Pricing unit in New York. Before Interactive Data, Ian was an economist and senior bond strategist in investment banking.

Richard Bibby, Managing Director, Alvarez & Marsal

Richard Bibby is a Managing Director with Alvarez & Marsal Valuation Services in London, with more than 18 years valuation experience across all industries.

He has worked on a variety of valuation assignments, focusing on advice to the asset management sector, in particular to private equity, infrastructure, real estate and corporate asset management firms.

Mr. Bibby has been responsible for financial reporting and tax-related valuations and opinions across all sectors, including Business Combinations (IFRS 3 / ASC 805 / FAS141), impairment testing, investment fair value reporting, share option-related valuations and related tax valuation advice, investment portfolio valuations (particularly to infrastructure), private equity, hedge and real estate investors, valuations for merger and acquisition activity, as well as reports in cases of expert witness, disputes and determination.

Some of his clients include: Aberdeen Asset Management, Abu Dhabi Commercial Bank, Aviva, Caisse des Depots et Consignations, Coller Capital, Deutsche Bank, Eurostar, Exel, First State Investments, HSBC, Investec, JP Morgan, Kaupthing Bank, Land Securities, London Stock Exchange, Morgan Stanley, Nuclear Decommissioning Authority, Nuffield Group, Royal Sun Alliance, Royal Bank of Scotland, Sankyo Seiko, Standard Chartered and Towry Law.

Before joining A&M, Mr. Bibby was a director in the corporate finance valuation group at Deloitte, helping to establish and lead its portfolio valuation group. He is a member of the Chartered Institute for Securities & Investment and the Chartered Institute of Taxation and is an alumnus of Imperial College, London.

He regularly speaks at valuation conferences and is often mentioned in the press as a source of valuation knowledge.

Lisa Cawley, Partner, Kirkland & Ellis LLP

Lisa Cawley has extensive experience in financial services regulation, gained over more than 20 years. She is recognised in Chambers, which has described her as an "oasis in the desert" when it comes to FCA regulation, and also "very precise and commercial" on AIFMD matters. It distinguishes her team as "the go-to source of counsel on the mutable regulatory landscape". She is also recognised in Who's Who Legal: Private Funds and The Legal 500, where she is described as a "master at all things regulatory in Europe" who "knows how to address the regulatory complexities that have come out of the financial crisis". In the IFLR1000 it is noted that "she is extremely knowledgeable and efficient. A fantastic attorney with extensive knowledge of the law and practical implications of the regulatory environment".

Lisa speaks, comments and writes regularly on regulatory matters and is an acknowledged authority in her field.

Ben Elder, FRICS - Global Director of Valuation, RICS

Ben is responsible for delivery of the RICS Global Valuation Strategy which has a key role to play in securing global financial stability through participation by the RICS in the development and application of International Valuation Standards. Ben is well qualified for this role as an Economist and a Chartered Surveyor and he has a particular interest is the interface of the economy and property markets.

Ben's has been a practising valuer and respected academic holding senior positions at Nottingham Trent University and The College of Estate Management. Ben joined the RICS as Global Director of Valuation in 2011 having served on various RICS Boards including International Governing Council as an elected World Representative.

In recognition of Ben's expertise in 2016 he was selected to Chair the IVSC Tangible Assets Standards Board and be a member of the overarching IVSC Standards Board. This appointment follows influential periods as a member of the Global Advisory Forum for The Appraisal Foundation in the USA as well as the Advisory Forum Executive to the International Valuation Standards Council.

Mark McMahon, Head of Alternative Investment Services, Alvarez & Marsal

Mark McMahon is a Managing Director and the Global Practice Leader of Alvarez & Marsal Valuation Services. He is based New York, where he also leads the Alternative Investment Services group.

Mr. McMahon brings more than 17 years of experience and specializes in the valuation of illiquid securities and interests across various strategies and asset classes employed by alternative asset managers.

Mr. McMahon provides valuation advisory services primarily to private equity, hedge funds and business development companies (BDCs). He has performed valuations for portfolios of illiquid equity interests held by large buyout and middle market private equity funds, while his hedge fund and BDC experience includes the analysis of private loans, including senior secured, subordinated and mezzanine debt, as well as convertible preferred and common equity, profits interests, warrants and other derivatives. Mr. McMahon's valuation advisory services have been relied on for financial and tax reporting purposes, as well as regulatory and litigation support.

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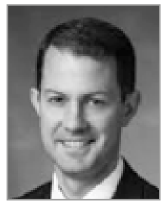
Mr. McMahon's experience also includes the valuation of private equity portfolio companies, as well as management, carried interest and incentive fee entities of private equity and hedge funds in connection with tax planning, financial reporting, dispute resolution and litigation, and restructurings.

Prior to joining Alvarez & Marsal, Mr. McMahon was a Managing Director in the Alternative Asset Advisory practice of Duff & Phelps. He has also held positions in the fields of corporate finance, investment advisory and corporate value consulting.

Mr. McMahon earned a master's degree in business administration from New York University's Leonard N. Stern School of Business and a bachelor's degree from the University of Richmond's E. Claiborne Robins School of Business. He is a Chartered Financial Analyst (CFA) charter holder, as well as a member of the CFA Institute, the New York Society of Security Analysts and the American Society of Appraisers.



Ryan McNelley, Managing Director, Duff & Phelps

Ryan McNelley is a managing director in the London office of Duff & Phelps, and part of the Portfolio Valuation service line within the Alternative Asset Advisory business unit. Ryan's clients primarily include alternative investment managers, including private equity funds, hedge funds, infrastructure funds, real estate debt funds, in both Europe and in the U.S.

Ryan specializes in the valuation of illiquid ("hard-to-value", or Level 2) investments, typically under the IFRS 13, ASC§820 or other local GAAP Fair Value standards used by alternative investment managers. Ryan's experience includes the valuation of the following asset types:

- Senior, subordinated and mezzanine debt; revolving lines of credit, delayed draw facilities, asset backed loans
- Common equity, preferred equity, convertible preferred equity and hybrid instruments
- Non-performing loans and loan portfolios
- Litigation claims
- Fund management companies and limited partner interest

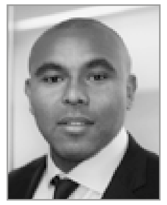
Ryan's other experience also includes the valuation of businesses and intangible assets for a diverse range of corporates, including satellite manufacturers, fixed satellite services operators, telecommunications companies, industrial manufacturers, car and equipment rental companies, as well as numerous other companies for tax and financial reporting purposes under the guidelines of U.S. accounting standard ASC §805 (formerly SFAS 141) and ASC §350 (formerly SFAS 142).

Ryan's past experience includes seven years in various finance and business management roles at Maxim Integrated Products, a Silicon Valley semiconductor company. Ryan received his B.S. in Business and Economics from Saint Mary's College of California in 1997, and his M.B.A. with a specialization in Corporate Finance from Cornell University in 2006.

He completed a business major, with a minor in finance at Eastern Mediterranean University, took classes in banking, finance, the stock market and investment and portfolio analysis, and completed his undergraduate program with the outstanding high honour degree in the year 2000.

Ollie Saunders, Lead Director – Alternatives, JLL

Ollie is the Lead Director of JLL's Alternatives team. With more than 20 years' experience, Ollie has specialised throughout his career in alternative asset types and infrastructure. He blends valuation professionalism with extensive first hand transactional experience. He has a wide range of experience, but with a core specialisation in Self Storage where he has had an involvement with most European portfolios from either a valuation, due diligence or brokerage perspective.



Leon Sinclair, EMEA Head Business Strategy and Development: Private Equity, Private Debt & Alternatives, IHS Markit

Leon is responsible for business in Europe including strategy, client engagement and product development.

Before his current role, Leon held various lead analyst and product management roles in Markit's flagship Fixed Income services.

Over the last 7 years Leon has been instrumental to Markit's drive to create new product offerings, especially around valuation practice and capital adequacy, due to the changing regulatory landscape. During this time he's represented the organization with multiple European regulators and industry bodies through industry working groups, Leon has also been authored in prominent industry journals.

Before joining Markit in 2010, Leon started his career at IDC, latterly running methodology and pricing for financial and hybrid instruments. Earlier in his career Leon worked a Structured Finance analyst. Leon holds a BSc from Loughborough University.

Chris Thorne, Director, Valuology, Past Chairman IVSC Standards Board

Chris is a senior valuation professional with over forty years' experience, primarily in the UK commercial real estate market but including significant engagement with specialists in other asset classes and institutions with an interest in valuation around the world. He is a Fellow of Royal Institution of Chartered Surveyors.

He currently is a director of Valuology, which provides consultancy advice to valuation firms on risk management and compliance. Between 2010 and 2015 he was Technical Director of the International Valuation Standards Council. Prior to this he spent over 35 years in private practice, providing valuation advice to banks, corporates and funds. He also received regular appointments to act as an arbitrator in valuation disputes and has significant experience as an expert witness on valuation matters.

He has also held several pro bono positions in relation to valuation. From 1993 to 2010 he was a member of the RICS Valuation Standards Board, which included a spell as chairman of the Red Book Editorial Board between 2000 and 2008. From 2008 – 2010 he was Chairman of the IVSC Standards Board.

DUFF & PHELPS

Keenan Vyas, Director, Real Estate Advisory Group

Keenan Vyas is a Director in the London office of Duff and Phelps where he leads the Real Estate Advisory Group in the UK. Keenan has over 10 years of experience valuing and advising across all real estate asset classes for a variety of clients including private equity firms, hedge funds, pension funds, developers, and real estate investment trusts throughout North America, the UK, and Europe. His work includes valuation and consulting for financial reporting purposes under both local GAAP and IFRS, transaction opinions, and investment property portfolio tracking for assurance testing. Keenan also has experience advising on issues surrounding site selection and market value determination for re-alignment and closure of property holdings.

Keenan holds a Bachelor of Science in International Relations with an emphasis on Global Financial Markets and Economics from the University of California, Davis.

He is a Practicing Affiliate of the Appraisal Institute, an Associate of the Urban Land Institute, a member of the Commercial Real Estate Development Association, and an Associate Certified Commercial Investment Member.

PEI Alternative Insight

Claire Wilson, Editor, Private Funds Management

Claire is the Editor of PFM which covers alternative assets financial, legal, regulatory and operational matters. Before joining PEI Media Claire spent almost three years covering European energy policy and regulation.

PANEL SESSION: **PRIVATE DEBT VALUATIONS**

Ian Blance (IB): Private debt is a very hot topic at the moment and from my point of view it is relatively uncertain how robust are the valuation approaches for this asset class. We are going to discuss this today.

Mark McMahon (MM): I think the most productive time here for us is going to be to talk through some of the methodologies and the data we rely on - the process we use. There's not going to be a new way of valuation that comes out of this discussion. The methodologies that we employ have been pretty tried and true for several years now.

Gone are the days where there was three values for a piece of debt. If it was performing, it was par. If it was outperforming, it was in its call premium and if it was distressed, it was an 80, 60 or 20 or whatever. It's much more nuanced now how you look at yields either through indices and we can talk about all these types of things.

Also interesting is not just what we do but how we do it. There is AIFMD (and AIFMD II) and the new, mandatory performance framework that's coming out in the US, driven by the SEC through the AICPA and other accounting guidance organizations. They're looking for more accountability, they're looking for more rigor, they're looking for more consistency and those are the things I think that are really going to kind of take center stage for us and also for funds.

This is just not for people like us to do when we work with our clients. It's the valuation professionals and investment professional that are our clients. That's still to be determined but I think we can maybe blend in some of these thoughts.

> ***There's not going to be a new way of valuation that comes out of this discussion. The methodologies that we employ have been pretty tried and true for several years now.*** Mark McMahon, Alvarez & Marsal

IB: Yes, I think the intention of this session is not to come up with some kind of revolutionary new way of valuing private debt. It's really more to highlight the advances that have been made over the last few years to come up with a much more defensible and robust approach.

The first discussion topic is considering the difference between intrinsic and fair value, and the main kind of issues that would need to be taken into account.

Ryan McNelley (RM): This is something that we continue to battle with - perhaps less so today than five years ago - where we get asked the question "Why do I need to fair value this debt when I will be holding it to maturity and have no intention of selling it. There's no market for it." Those are comments that we hear a lot and the accounting answer is that the fact that you hold to maturity is irrelevant, the question is what would you get were you to sell the investment today and in order to come up with that you obviously have to simulate what sort of a hypothetical market participant transaction, "What would somebody pay you?".

Of course the original yield is what always gets brought into the argument – "This is an illiquid piece of paper. I couldn't sell it if I were to try to sell it, I'd have to take a big discount." That doesn't necessarily hold up though when you think about the fact that the original deal already contemplated this and the original yield reflected the fact that you were buying into something illiquid on day one.

There are a lot of funds of the market - I think more so here in Europe than in the US – that continue to gravitate towards cost or this intrinsic value because it's easier to a) calculate and, b) defend. But limited partners and accounting guidance insists on fair value making for an inconsistent situation.

Leon Sinclair (LS): There is an inherent degree of difficulty in arriving at a company's intrinsic value when looking to ensure the debt is fully covered. Due to all the possible variables involved, such as the value of the company's intangible assets, estimates of the genuine value of a company can vary greatly between practitioners. Sometimes analysts use discounted cash flow analysis to include future earnings in the calculation, while others look purely at the current liquidation value or book value as shown on the company's most recent balance sheet. Ascertaining appropriate discounts to items also is a point of contention.

IB:When it comes to producing these values, what are the key parameters that need to be factored in?

Leon Sinclair (LS): I think this depends on where the asset sits within the continuum of private debt – for example a leveraged loan or a convertible note or are we talking about distressed debt? Frameworks and methodologies which are deployed should be appropriate for the nature of the asset. Obviously performing and impaired assets are treated very differently when trying to establish Fair Value.

Also, when one looks at the nature of the private debt market, a key distinguishing factor of the assets classes included under this banner, are flexibility with regard to funding with varied structures, characteristics and covenants that can represent diverse pay out scenarios. So I guess the answer is, it depends on what you are looking at across the continuum of risk return profiles and if the deal is performing or not before we look to target key parameters and methodologies. You have to understand the deal.

The way in which you build a valuation framework also depends on the objective of the valuation, should it represent fair value or not? Or should it only test for impairment then be held at cost? Has the client performed a detailed shadow rating on the portfolio company and followed a transparent replicable rating process that identified credit worthiness? Or is the best solution a positive assurance on work which has been carried out by an internal function?

As one would expect we follow IPEV guidelines for Fair Value assessments which helps us structure the logic and potential hierarchies of approaches.

So if we look at collateralised RE Debt most of the value may be driven asset coverage and impairment. For Leveraged Loans maybe that looks more like finding suitable discount factors from syndicated or mid-market loans and for mezzanine loans that may entail an Enterprise Valuation based on a market approach (multiples) or an income approach (DCF) to establish if the value breaks into the debt capital structure and if so how deep. If there's value in the equity classes and no break into the debt then we may want to use a market approach again with credit risk reflected in the spreads of comparable assets. Within a given approach it often makes sense to corroborate multiple techniques, and assumptions to gain a point of centrality to the valuation or justify the chosen methodology through a range of values.

This type of contingent workflow and consideration is customary when dealing with multiple tranches of debt and multiple series of equity classes in a portfolio company.

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PANEL SESSION: **PRIVATE DEBT VALUATIONS (CONTINUED)**

(LS): One thing we hear funds going but believe has material limitations is generic matrix based pricing, it really doesn't do the valuation of an asset justice nor does it necessarily adjust for points of difference. Where this type of approach makes more sense is in top down valuations of i.e. pools of SME loans.

> ***... when one looks at the nature of the private debt market, a key distinguishing factor of the assets classes included under this banner, are flexibility with regard to funding with varied structures, characteristics and covenants that can represent diverse pay out scenarios.*** Leon Sinclair, IHS Markit

IB: But are there any standard structures, or is everything a piece of unique bespoke paper?

(MM): There are definitely some standards. You can get into issues on whether you control the equity versus whether you don't. If you control the equity in theory, you can you sell the equity and recap the cap structure. If you don't control the equity then typically there's going to be some kind of a yield analysis done.

We can get into the specifics about that, but there's different types of yield analysis you can do. If you have a company where you have a good understanding of how the paper was originated - it's entry IRR or entry yield - you can usually look at that and use it to calibrate the paper, based on observations on how the company is performing since the underwriting and also what you see in the market.

There's a little bit of judgment for both of those. That's where independent valuers come in. We have to look at that information with a healthy degree of skepticism and make our own call on what ultimately the yield should be.

If things have changed a lot for that company over time maybe that entry yield is no longer relevant. Maybe there has been a lot of bolt-on acquisitions, maybe there's been a lot of change in the industry. Oil and gas and retail are great examples here. Things have fundamentally changed in these industries, and here you do more of a yield build up, using things like capital asset pricing model approach.

Then finally, where there's more distress you might be doing something from a recovery perspective or going even further down, you might be looking at things from a liquidation perspective.

IB: It has been mentioned that the original transaction and the original yield is a key kind of starting point for the analysis. How much of that original transaction needs to be taken into account throughout the life of the issue and also how much influence should the investor have in this process?

(RM): I think those two questions are invariably linked. When building up a discount rate one of the most useful tools is calibration, especially for performing credit. Another is comparable indices. This usefulness declines over time, and also as the credit degrades.

If debt was issued at, let's say 10%, on January 1, 2014 and here we are three years later, the company is under-performing, leverage has increased, then that original yield becomes less useful.

Similarly, using average yields for lower quality debt can result in strange results. An average yield might be let's say 7% but there's a wide distribution, everything from sort of 4% to 12%. One of the reasons for that wide distribution is that the credit ratings aren't always up-to-date so the loans that make up the index aren't necessarily completely current. Another reason is that there are other things that come in the play, covenants and the like.

In these circumstances you are going to look at other ways of building up this analysis, like using the CAPM.

IB: We have mentioned company performance information, for which you often have to rely on the investor. Is that always forthcoming?

(RM): Generally, yes. It's seldom that we have a situation where that type of information is not available, although it does happen. So we make our own conclusions about the credit quality based on the financial performance of the company.

Where we need input from the investment manager on is things that are not apparent in the financials, such as a new cost cutting strategy, new acquisitions, industry dynamics, etc.

Our client is typically a fund manager who has spent maybe a third or a fourth of his time over the past year getting very intimate with the company and knows management, has visited the company, has visited the underlying assets and therefore has a lot of insight. We need to take that insight into account when we are assessing things like, the original business plan and entry yield.

But what's equally important is that we maintain a sense of integrity about how do we incorporate that information because, inevitably the guy who originally did the deal is going to be a bit biased that's where the independence comes in.

> ***Where we need input from the investment manager on is things that are not apparent in the financials, such as a new cost cutting strategy, new acquisitions, industry dynamics, etc.*** Ryan McNelley, Duff & Phelps

IB: I just want come to that point about the fund manager who originally invested in a company story. That's their baby and sometimes you folks have to go in and call this baby ugly, which nobody likes. How do you manage that conversation?

(MM): Our conversations with deal teams are very different than our conversations with controllers and CFOs. You talk to the deal team in a way that's respectful of their baby, but you push factually and sometimes you have to push hard. The challenge we have is that they are your client. They pay your fees but you're independent.

Over time I've learned that the company's specific issues that you learn are far more important in understanding what a correct or reasonable yield today is relative to what you see in index movements, or any comparable movements. Especially as you get into subordinated paper, especially as you look at indices like in the US second-lien market, which issues six to ten billion dollars a year, most of it energy heavy. How do you make assessments of indices in things like that, so you're really focusing much more on performance.

We need to understand those things, to read between the lines in the documentation you get, and the information you have and understand their value drivers and how they originate this. Ultimately they are the guys that cut the cheque to buy the asset.

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PANEL SESSION: **PRIVATE DEBT VALUATIONS (CONTINUED)**

(MM): They did the due diligence, it was competitive and you have to understand that - but again from an independent perspective. If you get all those things and triangulate all that and weight it through thoughtful judgement and some experience.

> ***You talk to the deal team in a way that's respectful of their baby, but you push factually and sometimes you have to push hard.***
> Mark McMahon, Alvarez & Marsal

IB: That seems quite the opposite from the kind of relationship between observed market data and publicly traded debt

(LS): I just want to touch on a couple of things about transactions. It really depends what the transaction represents. All valuation houses use transactions, but is that transaction a fair one at inception? Was it in competition and at arms-length or was the client a price taker? Are the counterparties related parties and could the transaction represent re-injections of finance? Could the transaction represent some kind of stress scenario or fire sale, was it in competition or part of a regulatory motivated transaction that may not reflect fair value etc? These are all questions that need to be asked by the analyst interpreting the transaction. I think there needs to be a healthy level of caution around the transaction itself, if the information doesn't pass through your sanity checks an open discussion with the client should pursue.

So essentially you do need to contextualize that transaction. But remember this could be the only piece of market based information which you have access to which is specific to that deal, so it's hugely important to understand the drivers behind the transaction.

That sanity check could be built up through different methods to justify the funding basis (qualitative and quantitative) such as stripping of financial statements and understanding the fundamental position of the company, the leverage and profitability ratios of the company, the management of the company, where it sits in its business cycle, the liquidity position of the company and associate country risk amongst other factors. Alternatively, information permitting, one could look at similar deals funded recently in more liquid markets to validate (accounting for transaction basis).

Challenges can arise when very different transaction levels are observed within a short time-frame on seemingly similar deals; this indicates a very dynamic discount / premium adjustment within a segment of the market moving fast.

On the topic of influence or involvement of an investor and/or a particular bias to the deal team involved. All of us have mentioned that it has to be done behind a screen to ensure independence, but of course these deal teams have lived and breathed the investment for some time and have undergone (in most cases) detailed due diligence on the portfolio company. Due to this they have really important contextual information to add into that process and we would be naive not to be open to that contextual input. It doesn't mean that it necessarily directly impacts the valuation but it sets the scene as to what the investment rational was at the point of funding.

But ultimately these are mainly topics covered off within an onboarding process which is a major point of collaboration between investor and valuation advisor. This involvement clearly diminishes over time unless there's a material change in the fortunes of the portfolio company, for example Leverage taking a couple of turns higher, which may lead to rebasing of techniques, assumptions and proxies. Under an audit process the use of the funding transaction is favorable but over the course of time the transaction can become less relevant.

IB: The reason as to why I'm poking at the influence of the deal and the investment manager, is that in the publicly traded debt valuation environment the investor's view on the attractiveness or otherwise of the investment that they happen to buy is largely irrelevant to valuation. If an investor thinks that something is fundamentally undervalued and buys it expecting it to go up, it's not the valuers job to reflect that expectation in the valuation. The valuation reflects what is worth today and whether the investor thinks that that is cheap or rich, it is not the concern of the valuation shop to assess that.

In the private debt world we are talking about, however, the investor and deal team view on the attractiveness of the asset perhaps can be reflected in the valuation. How do you as independent valuers control against this becoming an undue influence?

(MM): To your point in terms of a transaction that takes place and they think they bought it cheap. If we see secondary transactions that are market, that took place between a willing buyer and a willing seller, that is maybe a reset for you even if it's something that moves you materially away from a yield perspective or an overall pricing perspective from where you were in the past.

IB: Yes that's what I was referring to. You see something else in than the market place that is disconnected from the way the investor sees the deal.

(MM): There are going to be instances where if you get some good individualistic assessments from an investor on specific purchase circumstances. You will also see broker quotes out there. They were a big deal before and there's a lot of scrutiny around them right now. "Who's the broker? Do they really stand behind it? Is there volume there? What's the distribution between the quotes? Why is this one an outlier?"

Those types of things also play into the analysis in different ways, but when we see money change hands, that looks fairly competitive, that's hard to get away from as a value point.

IB: Certainly under the accounting standards, that would be primary factor. If there's a transaction on a specific day in that specific instrument that's what you use right?

(LS): Yes, when you look at level one and level two valuations, it's relatively easy, especially if there are transactions or volume behind a firm bid and an offer associated to an asset at a certain point of time, you would certainly look to incorporate that information. But with level three assets you naturally have to incorporate different and potentially more techniques in order to build a robust valuation process for the asset due to mostly operating in secondary transactionless, so observed transactions are mostly in additional rounds of funding and proxies to the asset.

I think we have touched upon the use of different sources of market based information that could be used to create proxies for a particular risk such as basket of specific instruments which are very comparable in terms of risk factors to the portfolio company debt but then needs to undergo specific adjustments. This could include, sub-sector adjustments, credit ratings adjustments, duration adjustments, region of risk adjustments etc. It could also be achieved by using combinations of assets that represent bespoke beta, it could be by using multi-variant factor curves or term structures or comparable entities and then adjusting for the points of difference. All these techniques really act as mechanisms to incorporate a variety of views to create a robust valuation.

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PANEL SESSION: **PRIVATE DEBT VALUATIONS (CONTINUED)**

> ***All these techniques really act as mechanisms to incorporate a variety of views to create a robust valuation.*** Leon Sinclair, IHS Markit

IB: This raises the issue of the way that all of this vast range of information gets delivered in a valuation report. Where does that go? To the GP, the LP's? Where does it stop?

(RM): Well it obviously depends on the context - who's engaged you and what is the report being used for. I think most of the three of us in our respective companies are only engaged in the context of financial reporting for funds so we have clients who have different requirements. Some clients want as little information as possible other than an endorsement of their position.

IB: Is that what you're going to call a positive endorsement?

(RM): Yes positive assurance, it's opinion is to whether their valuation is reasonable. Although I would say that for the most part when we still do all the same work as we would if we were providing an independent range of values. I believe very strongly that, in most cases we will be able to do something completely independent and then would just simply make a judgement call as to whether our valuation is generally in line with the client's. If it is, we'd feel comfortable with it and send our report but we take that signature very seriously.

We all have our firms reputation to consider and often times are more aligned with the CFO, or the Controller or Chief Operating Officer – those that are ultimately putting the financials and NAV together - not necessarily the fund manager.

> ***Some clients want as little information as possible other than an endorsement of their position.*** Ryan McNelley, Duff & Phelps

IB: I would like to talk a little about subordinated and distressed debt, since this is where the degree of subjectivity and judgment comes more strongly into play. Are there any special considerations you have to consider when looking at that?

(MM): This could be a whole different day of discussion? The starting point for all the analysis is to have a view on enterprise value. With first lien debt, you then look at whether it is covered, and if it is then move to a yield analysis.

Your view on enterprise value also changes over time when you're calibrating because sometimes the markets are telling you things that EBITDA or whatever's driving your leverage factor are not right now. So you have performing debt and you can have enterprise value that's declining and an equity cushion that's declining, giving signals that you don't necessarily see immediately from just a cash flow metric that you're working with.

Now, if you're looking down the chain to subordinated debt, that comes through much more clearly and if you have a subordinated debt that is levered four, five, six times with very little equity, minor changes in cash flow, minor changes in how the markets are viewing these types of companies can have a very big impact on that paper. So, while you want to understand terms, you want to understand effective yield and maybe the contractual maturity, but also maybe how do they think they'll get taken out of this.

Usually subordinated debt, second lien debt that's been on the market for five years, that's usually a problem. You would have expected this to have been taken out earlier so you're thinking about things from that perspective and this also has to be amalgamated into what you think will be the yield over time. Maybe that debt was issued as delayed equity issuance, they just couldn't issue debt or equity at that time for various covenants or governance reasons and so you want to understand how they could be taken out over time and eventually replaced by equity capital.

As things get more distressed then you're looking at that yield from a more blended perspective. If you recap this company's today, for example, you would look at a leverage level of x amount versus y amount versus z amount, you would expect incremental additional yield to come in up to an equity yield based on maybe organic CAPM formula. You can blend that by weightings that might give you a new relevant yield to use at that time. So, that's how I look on sub-debt that's going to be gradually starting to underperform.

On the distressed side, it's kind of more of the same as company starts breaking covenants. Maybe it's not performing anymore, what's the view on a restructuring? How is this going to work out? Is someone looking at this month have a loan-to-own perspective or this is a pure equity yield, this is going to be recapped out and they're going to own x percent of the equity based on recapping this to a level that supports its capital relative to its peers out there? We have a large restructuring team in A&M, so we actually get a lot of guidance from our folks from running guideline comps and things like that, that can give you some ideas of what the right equity ratio should be.

Again, you do have to look at cash flow volatility on an individual company basis but those are all things that are taken to account when you're looking at those and there's much more, frankly, but I don't want to be over-winded with that discussion.

IB: Do you folks get involved at all when it gets into true recovery and legal scenarios where a company is in Chapter 11 or even worse? Is it just a guess at this stage?

(RM): For this situation there is an entire toolkit of methodologies and techniques but you may start looking at doing scenario analysis. What is the recovery probability here? The business might be liquidated, it might not. Probabilities of liquidation, it gets very difficult, especially here in Europe where you have different insolvency regimes across every different member state and so what the regime says here in the UK is not the same thing as what might happen in France or Germany. So you can't just rely on a single formulaic approach to saying, "Okay, well if this company liquidates, we'll just discount all of the underlying assets by this percent".

Generally, in restructuring scenarios we also take input from our restructuring team, they've got expertise across these different jurisdictions to try to understand, what are the scenarios where you're going to recover? How is the particular piece of debt that your valuing fit in with all of the other claimants and the cap structure including pensions and all those other things.

As mentioned, this is a discussion that alone could last half the day in playing out all the different scenarios, so yes it's a challenge.

One other thing I would just mention about distressed debt that is we shouldn't lose sight of transactions You can oftentimes have a lot of trading going on around it where people say, "I don't have an appetite to sit here and go through this restructuring for the next two years until I finally it get what recovers, so I'm going to find a buyer."

Continued overleaf

PANEL SESSION: **PRIVATE DEBT VALUATIONS (CONTINUED)**

(RM): That's really important because we always have firms that say, "I'm a special situations investor. I always buy things for less than they're worth". When you hear that the alarm goes off in your head you start thinking about what exactly that means.

In such a case we have to challenge the assumption that it's an arm's length transaction. That being said, oftentimes those distressed deals do get sold for very low prices which really do reflect a lack of appetite of investors going through the whole restructuring process.

IB: Even in the publicly traded market you often get a fire sale for a specific reason and the argument is always deployed by other funds who hold the same deal that "I don't need to value my holding of this instrument at this fire sale level because I have no need to sell it for those reasons". It is then a big challenge to justify this to regulators and auditors where a trade in the asset was observed.

Our final question is on AIFMD. The Directive has the concept of the External Valuer and I'd like to get your firm's perspectives on this role.

(LS): Firstly the market for AIFMD External Valuer services is in its infancy so trends could change materially.

AIFMD for us has definitely increased awareness in the industry on the use of third party providers.

Having said that, a formal External Valuer is something that funds mostly don't engage in as a first step. Our most common role is typically to help an internal reviewer process with their obligations under AIFMD. Now they're segregated from the deal team they need help in performing that function behind a Chinese Wall from the deal team whilst their remuneration cannot be linked to the assets performance. To do this well is extremely hard for even seasoned valuations analysts without the assistance and verification offered by independent 3rd parties.

However, we do see External Valuers appointed to European funds where real-money investors are coming from different jurisdiction. Some overseas real-money accounts see AIFMD external valuer and believe that this is the highest standard of valuation governance which could be borne and push the manager to seek an External Valuer to the fund.

Though regulation can compel people to change, business is much more responsive when change delivers a commercial advantage to those who act.

> ***An official External Valuer in the context of AIFMD is something that funds mostly don't engage in as a first step.*** Leon Sinclair, IHS Markit

(RM): This is a topic that we address very carefully when we head into a conversation with prospective clients about whether they engage us.

The Directive allows for funds to value internally provided they meet some independence criteria. There's obvious scepticism around whether anybody can be truly independent if you are being remunerated by the fund, but nonetheless they can choose to value internally. They can choose to engage us in a review capacity or in a sort of advisory capacity to this internal process or they can engage us as an External Valuer.

When you get into the depths of those discussions you start to realize that for both of us, the only difference between engaging us in an advisory capacity vs as External Valuer is liability. If we're engaged as an External Valuer then statutorily we can't cap liability. We become an insurance policy and nothing else.

Given this you start to think about whether we really wanted to bet the firm's balance sheet on nothing going wrong? What exactly are you liable for? If I think this debt is worth 99 and it ends up selling for the next day for 98, does that mean I can get sued for the difference? The answers is no, you can't really get sued just because you valued something at a different value than where it transacted.

You can get sued for one of two things:

a) You been negligent in performing your task. You just simply did not do what you're supposed to do regardless of what you came up the right answer or not.

b) Funds blow up and when they do lawsuits get filed and everybody gets sued regardless of whether you did anything wrong or not.

Certainly defending a lawsuit, especially when we have uncapped liability, can be extremely costly and the fees derived from doing the valuation work do not justify accepting this kind of liability.

IB: If I'm a fund lawyer dealing with a blown up fund and I see one of the parties in the case that's got an unlimited liability, it's top of my hit list right?

(RM): Yes. That's a real thing to be worried about. There are a lot of ways to make sure you don't misvalue something, but there's not a lot of ways we can prevent a fund from doing a poor job of managing the fund or there's not a lot that we can do to make sure that there's no funny business going on there. When that happens, everybody gets sued.

(MM): Yes, we typically act in an advisory role. As a practice leader, no engagement letter would get signed on those terms. You can do super caps and things like multiples of your fees, but I think in this instance that just doesn't work. Ryan makes a nice analogy on the insurance policy aspect of it. Certainly, I agree with that.

But I think the key thing to take away from this is the big mismatch in terms of AIFMD how it's currently written and what our scope of work has to be for the fees we are charging. Our work is a limited scope analysis for each investment we are looking at. We can't go to management and dig into them. We can't talk to the auditor of each portfolio company and dive in these details.

They might give us great information, on which we do a great job and we all feel very good about things, and there can be a blow up completely unrelated to what we do or what we saw. We were not given the information but if you're unlimited on your liability it doesn't matter and that's from our perspective just something that is not economically viable or fair.

In this instance if you actually signed an engagement letter with those terms based on what the AIFMD says and gave them that work product, we'd be exposing ourselves to liability. That fairness is lacking and we are not prepared to take it on.

> ***... the key thing to take away from this is the big mismatch in terms of AIFMD how it's currently written and what our scope of work has to be for the fees we are charging.*** Mark McMahon, Alvarez & Marsal

PANEL SESSION: **PRIVATE DEBT VALUATIONS (CONTINUED)**

(LS): One of the major issues driving funds not to use an External Valuer is a reluctance to give control of the NAV process to the external party. They would be on the outside of their performance measurement essentially so that's probably the biggest problem. In terms of liability, ultimately there is a decision to made as to if the remuneration will work versus the risk which is taken on.

(RM): Talking about AIFMD, it's up for review. The European Commission is willing to listen to the industry and the point was made earlier that it hasn't achieved its intended aim of encouraging funds to move towards independent valuations. We've seen a move towards independent valuations, but that has more to do with investors pushing and demanding then the regulator.

The regulator says, "You don't have to do this. You do a minimum, and the bare minimum is this". Whereas when an investor say, I'm going to withhold this $100 million cheque unless you meet certain governance standards. Then people like us get the call.

I would say there's room for us as an industry, when speaking on behalf of the ultimate stakeholder here which is the limited partners, the investors, to say what is in their best interest.

IB: It seemed like the strangest thing to me when the AIFMD came out that the alternatives industry for decades had been moving towards the idea of an independent valuation becoming an accepted standard. In fact, the AIMA rules still recommend this. Then this directive comes out that drives things in the opposite direction.

(MM): In the US the concept of the independent adviser on which we act is being one where the GP/fund manager has to take responsibility for their marks at the end of the day. There's no one that can take that responsibility ultimately for them unless they're being whammed down through a special examiner or liquidator that kind of scenario.

We mentioned earlier that if they're going to be doing this in-house, they have their own team, but remuneration is coming from the fund management firm. Often I see with my clients – perhaps some of the larger GP's – that they have evaluation groups which will actually be a fund expense.

IB: Responsible to the investor right?

(MM): Yes, so basically the investor who is pushing for this is effectively paying for it. When you have that, you can view the valuation firm as an honest broker in the process, an independent agent that is giving both investors and managers some advice or assurance on a range of values or a point estimate that helps them think through how they should mark their book. That's how it probably works best.

IB: With the review of AIFMD likely to produce AIFMD II sometime in the near future, let's hope that this is the scenario which we can achieve.

PANEL SESSION:
PRIVATE EQUITY VALUATIONS

Claire Wilson (CW): As discussed in the previous panel, there are some differences in the approach to private debt valuation between Europe and the US. I would like to start this panel by looking at the key issues in private equity valuation policies and procedures.

Ryan McNelley (RM): I think that sound valuation policies and procedures are applicable across all asset classes, and it is important to note that good governance in valuations is not just about independence. There is a lot that needs to be done internally to ensure you have proper internal practices and controls.

I'm always surprised at either the absence of a valuation policy, or where the valuation policy is little more than a paragraph. It is also surprising when valuation policy's focus purely on methodology with little mention of governance. What is really important in the valuation policy is, who is responsible for what, who signs it off, who is responsible for providing information, what was the role of the independent valuation agent, what was the role of the auditor? All those questions need to be in there.

Richard Bibby (RB): I've drafted some policies and procedures in the past and there are examples of best practice out there, in terms of The Hedge Fund Standards Board, the IOSCO Principles and AIMA. One thing I would add in addition to the overall governance, which is very important, is not to be too prescriptive in any guidance policies, because one can't foresee today exactly how the fund or its investments will transpire in the course of the next four or five years.

Having a too prescriptive valuation policy based on the context and the environment at the time that the investment was made can sometimes not stand the test of time.

Leon Sinclair (LS): A good example of that is where you have a fund that changes strategies but wants to keep some consistency or standardization across the policies of various strategies and funds. If the policy is too prescriptive and too customized to the old strategy, then this can prove very difficult to assimilate it to new strategies and workflows.

I would also stress apportionment of responsibility as a key component of the policy, not only on who is responsible and what the methodology and operational procedures are, but also for any ongoing valuation decisions or overrides and changes that may have a material impact on the NAV. This should be embedded within the procedural framework and valuation policy of the firm.

> ***I'm always surprised at either the absence of a valuation policy, or where the valuation policy is little more than a paragraph.***
> Ryan McNelley, Duff & Phelps

CW: So, with policy and procedures in place, what would be the main considerations when valuing investments in venture and early stage companies?

(RM): The challenges that you face in valuing a more well-established private company are amplified when it comes to early-stage companies. Financial information is limited, projections are speculative and you have all these things to contend with.

The prevailing wisdom is to use a last round financing approach, where calibration becomes a useful tool. That is not to say that this should be taken blindly. We have all seen the data on early stage companies and how many will likely fail. It is also apparent, even amongst the larger 'unicorns', that there are rounds of down financing going on and that there is a concern over over-valuation.

One of the biggest challenges is of reflecting reality as early as it becomes apparent when a business is not going to live up to its promise. As that date from last round financing goes further and further in the past you need to look at how the business is performing, relative to those expectations.

(RB): It is unfortunately a fact of early stage investing that the majority of businesses are not likely to survive for longer than three or four years. Quite often a lot of these businesses are only as good as their level of financing. It is very difficult to value these early stage companies and in my view, you should take each one on its merits and you must know the fundamentals of each business that you've been asked to value.

> ***It is unfortunately a fact of early stage investing that the majority of businesses are not likely to survive for longer than three or four years.*** Richard Bibby, Alvarez & Marsal

CW: Would you tend to value venture and early-stage companies more frequently than established ones?

(RB): I think that it tends to be the more established private equity funds who use independent valuation specialists, whereas a lot of venture firms tend to value their investments themselves. In that respect they tend to use the last round of financing approach.

(RM): I would add that there's a bit of skepticism out there that anything other than last round of financing is just crystal ball gazing. Often times these are novel businesses with disruptive technologies and are any of us in a position to assess the viability of these business plan and make a valuation call on them? No, but what we can do is provide a good challenge to the valuations across the portfolio.

When looking at early stage investments, in our experience, everything is marked to last round – that is just the methodology that everybody uses. We find lots of examples of where the whole portfolio is marked to last round, and for the bulk of investments, that's appropriate. But maybe for a small number the last round was, say, two years ago and the company could be way outperforming or underperforming. In these cases you're going to have a hard time arguing that it's value should be based on the last round of financing, and we would challenge this.

Then the other thing is, we see a lot of people making the assumption that all of the share classes have the same economic rights but oftentimes they don't. Marking different rounds of financing at the same level can produce incorrect valuations because your share class may have demonstrably different economic rights than the one used as a proxy.

Continued overleaf

PANEL SESSION: **PRIVATE EQUITY VALUATIONS (CONTINUED)**

(LS): Whilst the valuation agent should understand the investment thesis I think it is dangerous for the independent valuation agent to get caught up in the growth story of the company. Often the management or the investor will want to value against the investment thesis, but the role of the independent valuer is to validate and reflect KPI's, as suggested in the business plan, versus reality as the investment evolves. Therefore, if there is a deviation from the projections we need to make sure this is reflected in the valuation.

Let's assume the revenue target at year 3 of the plan misses by 5%. Enterprise valuation isn't necessarily impacted on a like-for-like basis (5%), it's important to keep in mind the trajectory of the portfolio company's' development. This needs to be done in discussion with the investor, since they may have access to key information (such as management justification and context for the revenue miss) that the valuation agent does not.

It is also important that, if the transaction wasn't that recent, there is an adjustment for the idiosyncrasies which form the market discount or premium.

> ***I think it is dangerous for the independent valuation agent to get caught up in the growth story of the company.*** Leon Sinclair, IHS Markit

CW: And what is the main considerations when evaluating investments and companies with complex capital structures? How do they differ?

(RB): We see this quite often and the obvious answer is to fully understand what complex structure is – that could be half the work involved. These things are structured for a reason and it's important to understand this. You also need to look at how the waterfall would work in various circumstances, whether it's a sale or another financing round, that sort of thing. That's your key to establishing how you allocate your value of the enterprise of the whole.

(RM): I couldn't agree more. If it's complex waterfall, it's complex for a reason. Rather than see some of these features as not important, oftentimes it is the most important thing to understand. For a conversion option, for instance. When is it going to convert? Is it mandatory? How long is it going to convert? What are the expectations around it? It can take a long time to understand these because the existence of those complexities in the capital structure can give a lot of insight into what are the real expectations in the business.

CW: Okay, so let's ask you, Leon, what are the key calibration metrics in private equity valuation?

(LS): Well, at inception we want to calibrate against the facts which manifest themselves in the transaction itself.

Many valuation use transactions, but is that transaction a fair one at inception? Was it in competition and at arms-length or was the client a price taker? Are the counterparties related parties and could the transaction represent re-injections of finance? Could the transaction represent some kind of stress scenario or fire sale, was it in competition or part of a regulatory motivated transaction that may not reflect fair value etc.? These are all questions that need to be asked by the analyst interpreting the transaction. I think there needs to be a healthy level of caution around the transaction itself, if the information doesn't pass through your sanity checks an open discussion with the client should pursue.

Then the valuation agent would ordinarily turn their attention to legal documentation such as the shareholder agreement and essentially from that point are look at different routes to establish views on enterprise value. There are several different options based on different sectors, the drivers of those sectors, the stage of the business and its business model profile, these components typically contribute heavily the methodology framework deployed. Of course, relevant calibration points also come via closed deals elsewhere in the sector.

Most valuations for companies with a track record would be based on some form of comparable approach. Here the key drivers are understanding not only what multiples to assess the business by but also what proxies best reflect value. However, where possible, there should be multiple layers of analysis of the peer set to really make sure that the right selection techniques are being used. To do that, we may use techniques such as regression analysis of financial ratios of comparators or to ensure that we accurately adjust for points of difference. This is something fundamental to IPEV guidelines and hence using adjusted multiples should be favored over simple averages. However, if material relationships aren't determined through the points of difference analysis the valuation agent should not data-mine to satisfy such adjustments.

Typically, there is not just one multiple or lenses to approach the valuation and in most instances one's looking to corroborate enterprise value via various appropriate valuation techniques. Note, there may be various types of ratios within a multiples approach which you may want to use and then weight the impact on the valuation. Alternatively, depending on the size and the stage of the company, the agent may choose to use an M&A approach to calibrate throughout the life of the deal in a heavy M&A sector or if there's a route to IPO / trade sale for the portfolio company being analyzed. Calibration is not something you do at inception and forget. However, the valuation agent must be comfortable there's observable, evidential and material changes in market that underpin the ongoing transaction basis adjustments, obviously the bespoke beta component of the valuation is adjusted for with new financial performance information.

(RB): When I first came across calibration I was very skeptical to be honest. Calibration is historical - let's look back at what happened in the past and use it as a benchmark for today's value. I don't really like that very much since I prefer to focus on the situation today, not last week, last year, or, as is typical in the private equity case, four or five years ago. Nobody looking to buy business today is going to look back five years and what happened thereafter.

What I've seen in terms of methods and metrics is a private company with a public peer group, which allows you to calibrate a multiple against that peer group. Using this going forward, there is no reflection of how the company or its peer group might have changed. Have you improved the business, has it grown, is it now the market leader, has it fallen? You have to support what has changed over that time.

So, calibration to me is a double edged sword, it can really help to help position the value of your investment, within a portfolio or group or peer set. But it can be a hindrance because if you have done really well in terms of moving the business that you acquired on, improving efficiency and taking out costs, this will not necessarily be reflected.

> ***...calibration to me is a double edged sword.*** Richard Bibby, Alvarez & Marsal

PANEL SESSION: **PRIVATE EQUITY VALUATIONS (CONTINUED)**

(RM): I wouldn't disagree with any of that, all though I will say that any time you value a business you have to look at some sort of comparable transactions. You might look at market comparables or those for similar businesses, accepting that those are different businesses.

But, a comparable transaction in the subject business, obviously, carries a lot of weight in your calibration although it diminishes in importance over time. The guidelines that are out there, are there largely to keep valuations honest, but I agree, it's only useful to a point.

The other point that I would make that is that we have to remember that private equity prides itself in creating unique alpha. Having bought a business they typically transform a business with the likes of bolt-on acquisitions, cutting the cost structure, trying to achieve top line synergies and what have you. The very nature of that diminishes the usefulness of calibration, because when you're a year, or two years out, you have a business that is completely different.

The last point I would make when it comes to calibration is that it is all a big exercise in calibrating between the entry and exit. When you're one day into the deal, the deal itself is going dominate it in terms of influence, but when you're a couple years in, you're starting to look what are my next options? What kind of business do I have now and where is the potential exit?

(LS): That's a very good point and I agree that there is time decay to the influence of the original transaction; sometimes this decay is very early in high growth portfolio companies. In some cases, transaction basis has a slower time decay remains relevant for longer, both in your portfolio and amongst the peers. If at any point there is a divergence of performance that leads to a re-basing, or re-calibration of the deal. Calibration is not a static measure.

CW: Has Brexit had any influence on this?

(RB): Not necessarily on calibration. It's interesting that there's really a lot of uncertainty but people are actually just getting on with their life. There might have been a little bit of, trepidation and delaying, getting deals done before the vote, but I'd say investors are still fine. Maybe less so for the big mega deals, but in terms of middle market transactions it seems to be business as usual.

(LS): Being a long-term, illiquid asset class, the effects of Brexit on Private Equity markets will take time to emerge.

Both GPs and LPs are likely to become more focused on underlying currency exposures in their portfolios given the likelihood of increased currency volatility in future. It's likely that LPs will assess their exposure to GBP investments and consider whether this is appropriate in the post Brexit environment. Similarly, underlying portfolio companies with significant exposure to the UK economy will be analysed by GPs as these may be adversely affected, reducing valuations and possible extending holding periods of investments.

I think that there could be a longer-term influence on calibration here if, for example if the UK was to trade on a WTO tariff regime with the EU, business models of certain sectors under this occurrence could change materially and UK companies benchmarked against a European peer groups may become increasing divergent, but in all honesty it's way too early to tell. So, I think the point is could Brexit have an impact on this, absolutely.

> ***Being a long-term, illiquid asset class, the effects of Brexit on Private Equity markets will take time to emerge.*** Leon Sinclair, IHS Markit

CW: How often do you advise valuations to be carried out?

(RM): That depends on the context in which you're asking that question. But if a fund has agreed with its LP's to produce financial statements on a quarterly basis, then they must value the investment on a quarterly basis and they need to use the same level of robustness every time they report, full stop.

Your do sometimes hear people say "These are private businesses, not a lot changes over time, so we're going a light valuation every quarter and then each year when it's actually audited, when people are actually looking at it, then we'll do a good valuation". But you do have things like Brexit happening, and this might have an impact on certain businesses, so just to claim 'business as usual' might not be defendable. There are lots of idiosyncratic things that can happen in all sorts of business all the time. So if that's what you're committed to, then you need dive in every time.

In terms of third party support, that's a cost-benefit analysis. Some investors like to see an independent challenge and enhancement of the governance of your valuation process, but obviously that costs money. The three of us, don't work for free. Maybe the portfolio is independently reviewed less frequently, or only a proportion of the portfolio is reviewed. That is an economic decisions, as well as a governance one.

(RB): The point is, it varies. It depends on the fund, it depends on the investors, it depends on the style and the investment strategy. One thing I would say is, everybody manages the valuation process differently, - there is no one, standard approach for infrastructure funds or for a private equity, etc. I've pretty much seen every single type of approach.

At the end of the day the GP has to deliver on what they said they would do in their fund documentation. So, if that's quarterly, then somebody somewhere must undertake an assessment of the value of the investments that are appropriate to the quarter.

But, especially for recent funds, quite often the fund has written at the beginning in their valuation policies and procedures the timings and who will be responsible for it. Firms undertake the process in many ways, GPs need to have control over the process and to ensure it is documented and that investors believe that the process works effectively.

(LS): I think there can also be other situations outside of the documented frequencies where valuations can be required. It could be triggered by things like fundraising, transfers, or other material information flows which would merit an independent valuation. It's not uncommon for trigger events to be written into valuation policies for funds that have robust governance but again the LP agreement.

CW: We talked about the costs of hiring the third party. Other than to keep investors happy what are the advantages of choosing an external valuer rather than doing it internally?

(RM): As a GP, you are ultimately responsible for the valuation, full stop. You can engage the likes of one of our firms and if we misvalue the asset, you are responsible for our misvaluation. So what I would say is that when you engage us you do your diligence to make sure you are comfortable that we know what we're doing. Even when you get our valuation report, don't just take it blindly. Most of our clients challenge us and disagree with some of our assessments. We have that discussion, but they remain ultimately responsible for evaluation regardless of what we do.

So the real benefit of having the third party is to be able to demonstrate that independent challenge to their valuation to their investors. Some clients ask how we are going to make their life easier and take a load off their shoulders in terms of valuing their assets. The answer is that a third party report can be used to corroborate your values and demonstrate independence to your investors, but that does not relieve you of the responsibility of documenting things well on your own side. You should have your own internal valuation function, notwithstanding the fact that you've engaged us. You should have your own documentation and your own processes independent of our work.

Continued overleaf

PANEL SESSION: **PRIVATE EQUITY VALUATIONS (CONTINUED)**

(RM): There are some cases where clients genuinely don't know what something is worth and they genuinely do want somebody to help them figure that out, but in private equity, that's generally not the case. They generally have a view on the value - that's what they do for a living – so they don't, or at least they shouldn't, look to us to replace their evaluation function. So, I actually do think it really does come down to demonstrating good governance over valuation.

> ***… the real benefit of having the third party is to be able to demonstrate that independent challenge to their valuation to their investors.*** Ryan McNelley, Duff & Phelps

(LS): Typically, the internal resource of the fund which is used to value positions is costly as it's a front office skillset, so I do think there are some very practical operational efficiencies to be had in employing an independent valuation agent. But also, you do need to control that generation process. An official External Valuer in the context of AIFMD is something that funds mostly don't engage in as a first step.

(RB): The people that are more receptive to our services, tend to be one's that talk to their investors, more than others. Because it is investor driven, that's what governance is all about. If you talk to the deal guys they can do it all themselves, but it's the investors who are asking for transparency, visibility, an understanding of how decisions are being made. And if you have a third party report that actually says it quite clearly, that's how we've done it, that's how we operate and a discrete document that can be reviewed, audited and checked, it's very helpful from a governance perspective.

Another aspect around getting independent valuation is funds who have a small operational team. They don't have back offices, they're all outsourced, so they might have a CFO and maybe one junior analyst So, they actually need to have an outsource type of arrangement. Their own operational size might be one factor which means they want to go external for an valuation specialist.

Another thing that the independent valuers provide is consistency. Funds want to know that the methods and the approach to risk they are using is consistent with the rest of the industry.

> ***Funds want to know that the methods and the approach to risk they are using is consistent with the rest of the industry.***
> Richard Bibby, Alvarez & Marsal

CW: We've talked about the people having knowledge of the deal and the portfolio. To what extent would the deal team and manager be involved in the valuation process?

(RB): It depends on the funds approach and the structure. Sometimes they buy an asset and then move on to the next deal, sometimes the deal team buy it and actually manage it so there's consistency throughout the process. If we are talking about how people who are actively engaged in managing the asset should be involved, I think, it is important that they are. They should be provide information and clarity on how the investment is performing and operational aspects of providing information.

(LS): The role of the investor is to provide the helpful commentary / insight from management and the factual information that is needed to provide a valuation but also discuss with the valuation agent on the context and interpretation of that information. As a valuation agent, the use of this information must be defensible, the agent's use of deal team information must be applied in a manner that follows accounting standards. But let's be clear an independent valuation cannot be based upon opinion and interpretations of people who have vested interest in increasing that value of the holdings if for example the manager is in the process of raising capital.

(RM): I agree with what both Richard and Leon said, so I will take a different tack on it. If you're an electrician or a plumber and some guy hires you to fix the plumbing he's your customer - the customer's always right. So you go and fix the plumbing if he's happy then he'll recommend you to the next guy. Here we're in a very different spot because we're engaged by the GP but it's at the behest of the LP. The LP is the one that wants us in place. The GP has no desire to necessarily bring us in to challenge what they're doing just for the sake of their own internal purposes.

It puts us in a difficult spot when we're having these conversations with the deal team. We're there to challenge them. When we sign a report, we as a firm want to be sure that we're comfortable with what we're saying. It's not about simply getting the report together and saying, "Well, the asset valuation is this, the deal guy said this. That's just what it is." We're there to provide an independent challenge, otherwise there's no point.

That's just something we all as an industry have to keep in mind that that's the role we play and as long as we continue to play that role and get Limited Partners comfort then our presence in the valuation process is improving the overall governance, it's improving but the quality and the transparency of the information they're getting, then our industry will continue to flourish. If LP's get the sense that there's no point in having this because we're either not challenging or because there's rubber stamping going on then we're going to be out of work.

> ***… let's be clear an independent valuation cannot be based upon opinion and interpretations of people who have vested interest in increasing that value of the holdings.*** Leon Sinclair, IHS Markit

CW: The previous panel touched on how AIFMD changed the valuations process requiring independence. Have you seen any private equity specific change since the introduction of this Directive?

(RM): There are lots of different areas and fund types where AIFMD has an impact. When it comes to private equity, in general you have typically closed end fund structures where people are not going to be remunerated based on their own discretion with respect to the NAV. The focus on independence is not quite as acute here as it is in some of the other areas.

Continued overleaf

PANEL SESSION: **PRIVATE EQUITY VALUATIONS (CONTINUED)**

(RM): Bear in mind that this is ultimately for the benefit of the investors. If a regulator says, "Do this independently," you're going to do the minimum needed to comply, but if it's your investors, that's a different story.

(LS): A recent EY PE Survey suggested that there has been a threefold increase in the number of PE firms which are considering using independent valuation. It's hard to know whether that's driven by investor demand, more robust LPAs, or whether it's driven by the want to ensure independence to comply with AIFMD, but the trend is certainly there. In the Western European context, we find that national regulators have been relatively active over the last year and meeting, interviewing and assessing AIFs but also large Asset Managers with exposures to PE. In some cases, such reviews lead to governance and valuation recommendations that focus on independent verification. Increasingly we find risk and valuation groups want to get ahead of this.

(RB): If you asked me this 10 years ago and said, "What's the appetite for independent valuation in private equity?" most fund managers would turn around and say, as has been said already, "Well look, we're a close-ended fund, investors get their money when we get our money and vice versa. What is does it matter what the interim value is? Everyone gets their fair return in the end so the valuation today shouldn't be all that important. What we would like to do is to keep asset values marked conservatively and then when we sell an investment, the mark-up will look impressive, so let's do that, shall we?"

If you ask me that same question today I'd say that there's still that mentality there, but to a much lesser extent, and today it'd be very naive to take that same view because investors' requirements and demands have changed a lot in the last ten years. With the advent of fair value accounting, investors have to demonstrate to their investors, and their stakeholders and their auditors that the values that they're putting on their investments are a fair value.

How you do that? Well, you force it down the chain, force it out to your funds and your investment managers. It's not reasonable to think that investors are not interested in the current value of their investments in the fund. That has been the main driver for pushing independence into the process.

AIFMD itself, has put a regulatory aspect on it, and has formalized the investor demands for transparency, that's the process now. How far has that actually gone because, the regulations says somebody has to look at these checks and balances? I think 25% of the funds are using experts, that means 75% don't. These 75% have not really aligned themselves with what investors truly want but actually they're still investing in the funds anyway.

How far does this go? In the US, they have gone a lot further down the chain, because the SEC appears to be more active in this area and they are more willing to enforce. The reality is that AIFMD has had a difference but only to a quite limited extent. This in my view is largely because European regulators don't appear to be enforcing the valuation aspects of AIFMD. The next stage will be when a European regulatory does enforce an action and that's when I think we will see more and more take up of independent valuations.

(RM): Just to add a couple of things to this. There are two separate concepts here; one is an argument for fair value and then there's a separate argument for independence without reference to fair value. I think there's maybe two things that really demonstrate the need for independence in evaluation.

More and more private equity funds, are maturing and raising capital for more funds. When you're in fundraising there's a desire to put your best foot forward, and to demonstrate that previous funds have done really well. There is a danger in this scenario to be selective with the performance details. There's very well documented academic research that talks about how valuations seem to inflate when people are in fundraising mode, and that's one driving factor behind investors desire for independence.

The other is the secondaries market which is becoming more and more robust. People who are trading, the LP interests in this market are asking the likes of us to explain to them how should they take this and if they would, what kind of questions should be asked about how the NAVs were determined.

(LS): I might also just point that people like commonality of approach, and commonality of reporting terms and commonality of independence. All those things will ultimately push GP's down the road to make valuation more transparent.

> ***There's very well documented academic research that talks about how valuations seem to inflate when people are in fundraising mode, and that's one driving factor behind investors desire for independence.*** Ryan McNelley, Duff & Phelps

CW: Okay, we've covered all our discussion points, does anyone have any questions?

Audience: I'm interested to know, because the media's been talking about this more and more recently, if you take any account of what you see or pick up on social media, and sentiment, with companies that you're valuing and if you are having to change what you're doing because of that?

(RM): I suppose it may depend on the context, take Uber, for example, highly visible there's a lot of things going on every time, I think they're under pressures, because they continue to operate, in spite of the taxi boycott in New York City, when people are protesting, at the airports and things like that. So, they took a bit of certain negative press, I'm sure a lot of that was hung out over social media. I suppose it doesn't necessarily matter where the sentiment comes from, it could come from social media, come from just a general mainstream, or traditional media, it could come from anecdotes that we hear from our clients, it could have come from general knowledge that we have attentively in the market.

I would say, just as a matter of fact, a lot of the traditional Private Equity clients that we do work for and a lot of these SMEs where they're not as high profile so it's more difficult to log into Twitter and enter hashtag search or do something like that. If you're talking about the likes of Uber, yes, that's part of market sentiment, again whether it's mainstream, traditional media or new media, it's all relevant I think.

(LS): Agreed outside of the very high profile unlisted names the information flow just isn't there, and that's intentionally the case. An additional challenge is how do you take that sentiment and translate into the quantitative valuation. This would typically be outside the type of analysis performed in Fair Value. Even if there's positive talk about a company from a reputable source, how may this affect operations of the company, impact on their revenues and in turn impact on company valuation, it's very hard to translate that sentiment from social media into something we could justify, for example, in valuation of assets.

(RB): Those sorts of things have a direct impact that we can consider but I think we've always been taking this into account. Over the last 20 years we've been valuing businesses based on what is known in the traditional media and the impact that has had on pricing. I think social media is just a different version of the old traditional media. If something goes out on Twitter then the impact of that is almost as immediate as if it came out as a press release. Once it's out in the market one can assume that it's incorporated in general valuation metric that you're using.

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